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W. G. Rowe

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By W. G. Rowe

In spite of improvements and refinements effected from time to time in the practice of accountancy by progressive accountants, the surplus account continues to be the dumping-ground of many items which should properly appear in the profit-and-loss account.

As a rule, apart from the periodical balance of the profit-and-loss account and entries relating to dividends declared and paid, few transactions are of such a nature as to justify record by direct entry in the surplus account. Most of the "surplus adjustments," which appear so frequently in audited statements, will, upon analysis and due consideration, be found to be merely profit-and-loss-account items, if the functions of the latter account are fully understood.

The misuse of the surplus account as a burial-place for revenue items of various sorts has the effect of misrepresenting the results from operations as reflected by the profit-and-loss account. The sum total of operating results of a number of accounting periods as taken from a series of profit-and-loss accounts of a business should, normally, agree with the total of the relative profit-and-loss balances as extracted from the surplus account. Any differences should be rare and easily explained by special circumstances or some abnormal temporary condition. Such differences should consist only of extraordinary and relatively large items of such a nature as to justify their exclusion from the accounts designed to reflect the income and profits and losses and expenses incidental to the operations of a business.

Specifically, the following are not ordinarily proper matters for entry in the surplus account and should be taken up in the profit-and-loss account:

Omitted liabilities, or assets, incurred or acquired in prior periods and affecting operations.

Profits or losses on fixed assets sold or otherwise disposed of or lost.

Depreciation adjustments relative to any period.

Provision for known or anticipated losses on, or shrinkages in values of, current or working assets, including provision for bad and doubtful accounts, inventory reserves and taxes—of any period, whether past or present.

Amortization of deferred charges or credits.

Theoretically, the profit-and-loss account for a year or other period should embrace only income or profits and losses or expenses incidental to the operations and business transactions during that particular period. In practice, however, it is seldom possible to include or to determine definitely all items of profit and loss resulting from transactions of a given period within a reasonable time from the end of that period. Omissions will occur, estimates must sometimes be used (and the latter seldom agree with subsequent results) and expenses or income may be purposely deferred to some future period. Consequently, the profit-and-loss account of any particular period can not be taken as an exact record of all relative items actually resulting from or attributable to transactions occurring in that period. It should, however, include all items of that nature which are recorded or come to light in that period. The general rule should be that all revenue items, debit or credit, should go into the profit-and-loss account at some time or other. If an item of gain or loss is omitted from the accounts of one period it should go into the profit-and-loss account when entered on the books, no matter how much later. Otherwise, the periodical profit-and-loss account may become valueless as a record of operating results.

Special adjustments, arbitrary or otherwise, and involving substantial amounts, may be admissible as surplus items. Adjustments of this nature may arise from revision of book values of assets (such as credits or charges resulting from appraisals) or specific reserves for anticipated extraordinary losses or other provision of a special nature; but this class of entry is entirely different from the relatively petty gains and losses incidental to operations which have become a "surplus weakness" of many accountants.

The practising accountant in his capacity as an auditor may sometimes find it difficult to convince his client of the correctness of his attitude in discouraging "surplus adjustments," but such cases should be infrequent, and if the matter is properly presented by the auditor the opposition should be easily overcome. Subsequently injecting into the surplus account entries which are tantamount to admission of incorrectness of the recorded results of operations of past periods may be regarded as, in effect, a reflection upon the auditor who certified those statements. Unfortunately, such adjustments are not always attributable to the client or his accounting staff; they may emanate from auditors who labor under the mistaken notion that the profit-and-loss account of the period should embrace only certain items of revenue and expenditure, and that for recording other revenue items there is a choice between the surplus and profit-and-loss accounts.

The contention that certain items of gains or losses and expenses of an "unusual" or "extraordinary" nature should be excluded from the general periodical profit-and-loss account is not reasonable or convincing. "Unusual" and "extraordinary" are comparative terms only; and, in any case, the transactions from which such gains or losses and expenses result are incidental to the business—otherwise there would be no need to record them on the books of account of that particular concern. The profit-and-loss account, as its name implies, should be all-inclusive of items coming under that classification, no matter of what nature.

No confusion, ambiguity or misrepresentation need result from the strict application of the general rule that surplus adjustments should be avoided. The form and terminology of the profit-and-loss account should be such, in all cases, as to present clearly and accurately all its salient features; and the appropriate treatment of alleged "unusual" or "extraordinary" items presents no difficulty to the efficient accountant.

In conclusion, it may be well to point out that nothing written here is intended to suggest any limitation to an auditor's right to adjust the records of results of operations, period by period, in his report or relative statements, in order to meet the requirements of any investigation for a special purpose and so to bring out, by suitable regrouping, any necessary data or information. What is condemned is the direct entry in the surplus account of items which, in the ordinary course of routine accounting, should appear in the profit-and-loss account.